

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF BLUE GRASS RURAL)	
ELECTRIC COOPERATIVE CORPORATION FOR)	
AUTHORIZATION TO CONVERT CFC LOAN)	CASE NO.
#9011 FROM THE STANDARD FIXED RATE TO)	93-390
THE VARIABLE RATE EFFECTIVE DECEMBER 1,)	
1993)	

O R D E R

On November 17, 1993, Blue Grass Rural Electric Cooperative Corporation ("Blue Grass") filed a request asking the Commission to authorize the conversion from a fixed to a variable interest rate of National Rural Utilities Cooperative Finance Corporation ("CFC") Loan No. 9011. The term of these 35-year loans originally provided for a fixed interest rate for the first 7 years, after which, the rate would be renegotiated. Since the execution of these loans, interest rates have been substantially reduced and CFC has allowed borrowers to convert to a reduced variable interest rate. The current fixed interest for this loan is 8.5 percent. The variable rate applicable for this loan is 4.25 percent. On October 14, 1993, Blue Grass' Board of Directors voted to convert to the variable rate.

When converting from the fixed rate program to the variable rate program, CFC requires the payment of a conversion fee. The conversion fee for each loan is based on the difference in the interest rate on the note and CFC's long-term interest rate at the time the borrower elects to convert to the variable rate. The

difference is applied to the outstanding loan balance at the start of the borrower's next first full quarterly billing cycle for the time remaining until a repricing option would have been allowed. A one-time, up-front fee of 25 basis points on the outstanding balance at the time of conversion is added to the conversion fee. The conversion fee will be amortized over the remaining life of the rate maturity period applicable to the converted loan and billed in quarterly payments. The total conversion fee would be \$75,586.

Blue Grass provided an Internal Rate of Return ("IRR") analysis for the loan it proposed to convert. Under the IRR approach, the goal of the borrower would be to utilize the interest rate program which produces the lowest IRR. Blue Grass determined an IRR value for the following three different scenarios:

1. The current variable rate remained constant for the remainder of the pricing cycle ("Scenario I").

2. The current variable rate would begin increasing by .25 percent each quarter, beginning with the second quarter after conversion, for the remainder of the pricing cycle ("Scenario II").

3. The third scenario involved determining the variable rate which, when applied beginning with the second quarter after conversion, would result in an IRR value approximately equal to the IRR value resulting from the current fixed interest rate. Blue Grass considered this the break-even scenario.

Each scenario incorporated the impact on the IRR value of the quarterly payment of the conversion fee.

The analysis indicated that under Scenario I, the resulting IRR for the variable interest rate was lower than the IRR for the fixed interest rate. Scenario I resulted in a net cumulative savings of \$26,129. Under the assumptions incorporated in Scenario II, the resulting IRR was 8.838 percent, as compared with the current fixed interest rate IRR of 8.5 percent. The Scenario II IRR was only slightly higher than the value computed under the Scenario III, the break-even scenario. Scenario II resulted in a net cumulative increase in costs. One of the assumptions in Scenario II was the constant increase in the variable interest rate, starting in the second quarter after conversion. A net savings was projected to occur through at least the first six quarters of the current pricing cycle. However, Loan No. 9011 has 21 quarters remaining in the current pricing cycle. The escalating variable interest rate exceeded the current fixed rate over the remaining pricing cycle.

Blue Grass stated that it viewed the assumptions in Scenario II to be a "worst case" scenario. Blue Grass further stated that it would be constantly monitoring the variable rate and would shift to a fixed rate in the future if indicators show it to be advantageous. Blue Grass noted that no conversion fee is required to convert a loan from variable to fixed rates.

In its application, Blue Grass included a chart which showed the variable and fixed interest rates charged by CFC for the period January 1987 through September 1993. Upon reviewing this chart, it appears that the variable interest rate fell below 8.0 percent in

early 1991. Blue Grass indicated that seven quarters had been paid in the current loan cycle. This would indicate that the loan underwent repricing in late 1991 or early 1992. The Commission is aware that CFC will allow interest rate program changes at repricing, and that conversions from fixed to variable interest rates can be accomplished without paying a conversion fee. It appears to the Commission that Blue Grass missed an opportunity to convert this loan at its repricing, saving on long-term debt interest expense and avoiding a \$75,586 conversion fee. The Commission expects Blue Grass to monitor its loan portfolio and take advantage of similar opportunities if economically justified.

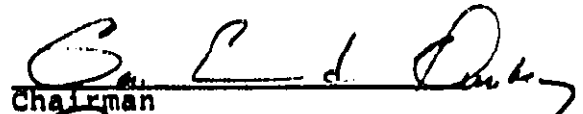
Based upon Blue Grass' analyses and the conditions presented in this case, the conversion of the loan should result in interest savings on an IRR basis and the loan should be converted as requested.

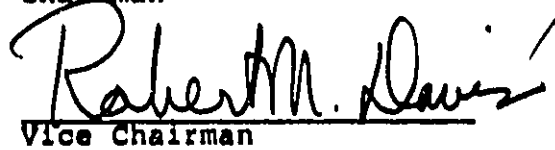
IT IS THEREFORE ORDERED that:

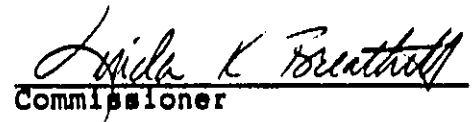
1. Blue Grass is authorized to convert CFC Loan No. 9011 from a fixed to a variable rate program.
2. Blue Grass shall notify the Commission of the closing date of the conversion and shall file, within 30 days of the conversion, all documents pertaining thereto.
3. Blue Grass shall file, along with its monthly financial report to the Commission, the current interest rate on its variable rate loans outstanding.

Done at Frankfort, Kentucky, this 24th day of November, 1993.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:


Executive Director